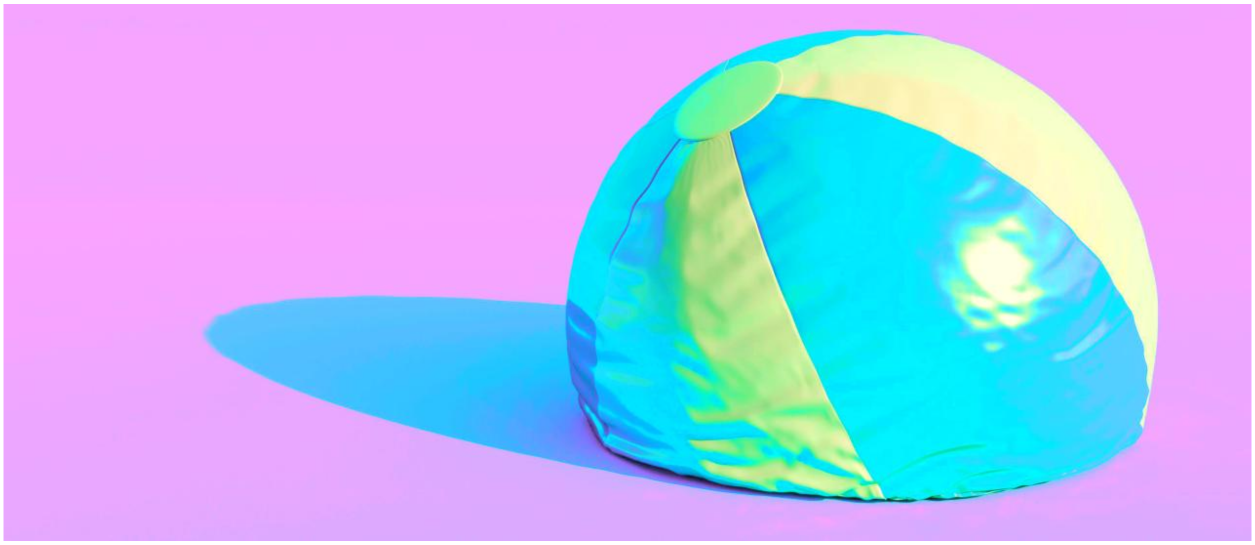
Deflation Woes: Can China Avoid Japanification?



By Pushan Dutt , INSEAD

What the world's second-largest economy could do to stop its spiral into economic stagnation.

As growth decelerates in China and the economy **slips into deflation**, there are fears that the country may be heading towards a situation reminiscent of Japan in the early 1990s, a quagmire that could take decades to shake off.

The question on everyone's minds is whether Beijing will make the necessary tough calls to ease the Chinese economy through this critical phase. Or will fear of political instability and social unrest make its leadership turn the other way?

Eerie similarities

China in many aspects resembles Japan at the end of the latter's "bubble economy". In the late 1980s, Japan experienced a monstrous stock and real estate bubble. When the froth faded, it led to a nation of struggling banks and an overhang of debt. The economic malaise coincided with an ageing population and declining fertility rates, with no counterbalancing immigration. Meanwhile, trade tensions between Japan and the United States culminated in the **Plaza Accord** that weakened the dollar against the yen in a bid to correct trade imbalances. Japan's exports became expensive and shrank.

The result of all this was a deflationary trap in which inflation remained below target for two decades, and eventually became negative. The values of houses, stocks and other assets fell year after year. Expecting prices to decline, consumers and firms postponed purchases. Only the post-Covid recovery and a spike in inflation worldwide since last year finally pulled Japan out of this trap.

China has many of the same characteristics. **Demographics have turned adverse**, the dependency ratio is rising, and the population is set to shrink. Not only does China have no immigration to cushion the decline, its fertility rate of 1.09 is lower than Japan's in 1990. And trade tensions with the US are at their highest ever.

More importantly, China has a wildly unbalanced economy. Household consumption constitutes an **abysmally low share of GDP** (38 percent in 2021, compared to 54 percent in Japan) while a bloated real estate sector accounts for more than 25 percent. As house prices fall, households will only become more risk-averse and spend less, further slowing growth. At the same time, manufacturing activity has contracted and exports have declined. Youth unemployment has reached record highs.

The 4 Ds: risks facing the Chinese economy

The good news is there are several key differences between today's China and Japan in the 1990s. For one thing, Chinese policymakers are unlikely to repeat Japan's mistakes and allow business and household demand to collapse. Further, the Chinese GDP per capita is still only 25 percent of the United States', whereas Japan's was 60 percent. As a middle-income country, China should have better growth prospects. Finally, China has vast foreign exchange reserves and a stable fiscal situation, which means it has sufficient fiscal and monetary flexibility to restart its economy. So, with a mix of luck and skill, the slowdown can be more cyclical than structural.

But China also faces a number of intractable problems. First, the investment model fuelled by infrastructure building and heavy industry has run its course. As countries become richer, investment is subject to *diminishing* *returns* (the first D) and growth inevitably slows down. But in China, the deceleration also stems from misallocation of capital (see Japan in the 1980s). Beijing's crackdown on tech companies under the slogan of Common Prosperity has discouraged private sector investment in innovative and knowledge-intensive industries, which are characterised by increasing instead of diminishing returns. Instead, investments continued to plough into real estate, where productivity tends to be low.

Demographics also play a role, but this is a gradual, long-term issue that acts as a drag on growth rather than precipitating a collapse. *Deglobalisation* seems increasingly inevitable, judging by **declining exports and foreign direct investment**, but again, this will take time to play out.

Debt, in contrast, is the key risk, especially among local governments and the smaller regional banks they organise, own and run. Real estate firms often hold large shares in these banks while borrowing heavily from them. These banks were the key drivers of the erstwhile heady growth powered by heavy investment and infrastructure construction. They are now also precisely where systemic risks have accumulated.

Beijing does have the fiscal firepower to combat China's debt problem, but it must make tough decisions on who gets bailed out, who gets haircuts and who bears losses. In the longer term, the government needs to tighten financial regulation related to overleveraged local banks and prise them from the control of a nexus of local officials and real estate companies. Among the systemic risks China faces, diminishing returns (partially) and debt are under the control of Chinese authorities. Lack of action on their part can cause growth to sputter.

Can China take the pain quickly?

The biggest lesson from Japan is "take the pain and do so quickly". For years, even decades, fiscal and monetary policy were misaligned in Japan. The government also did not let unproductive firms fail, leading to "zombie firms" and continued misallocation of resources. China can continue to keep the music playing by bailing out local banks and real estate companies as well as allowing real estate prices to rebound. Beijing has recently taken some steps, like cutting mortgage rates, to this effect. But this does little to correct house prices or correct imbalances in the economy.

Alternatively, Chinese authorities can address the imbalances and debt directly. In the short term, this would entail dealing with unsustainable debt levels at the local level, especially local banks. In the medium term, they should raise consumption's share of GDP by providing more fiscal support and building safety nets for households. Over the long term, they should encourage the private sector to shift investment from real estate to innovation-intensive sectors, through measures like a predictable regulatory regime.

Is China likely to take the pain? History should make us wary. We saw something similar play out in 2015 and 2022: China reached for the same playbook and kept the real estate party going, postponing adjustments and refusing to undertake economic and financial reforms. Both times, it was saved by strong export growth. But as the world economy slows, China can no longer rely on exports as its main growth engine. Rising geopolitical tensions mean stagnant exports and declining FDI as firms focus on risks and the resilience of their supply chains.

The measures above are disruptive but necessary for China to escape the dreaded **middle income trap**. Even if the Chinese leadership is more concerned about stability and maintaining control, it should recognise that improving living standards over time is the best way to achieve legitimacy and stability.

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